



## Financial Management—November, 2011

### Question

Dear Experts,

**Our organization is small, with a budget of just \$150,000 per year. Funders expect us to have an audit but the Board of Directors cannot see how we will cover the expense this year. Plus, some of our donors think we shouldn't spend money on an audit. Do we have to have an audit? Are there any other options that can satisfy funders without the big price tag?**

**Sincerely, Anonymous Development Director**

### Answer

#### **Audits: Your Strongest Evidence of Good Fiscal Stewardship**

There may be some options available to you, depending on the specific requirements of your funders, the firm you select to perform the required services, and the direction your Board of Directors is most comfortable taking.

First, you should check with your funders regarding their requirements, even if they are explicitly stated. Ask if your organization could provide a review, instead of an audit. A review provides a lower level of assurance than an audit by simply attesting to the financial statements being properly assembled and conforming in the most material aspects of the applicable accounting rules regarding reporting. It does not provide any assurance regarding the effectiveness of your internal controls, or the reasonableness of the reported balances. As such, the audit firm performs considerably less work which ultimately translates into a lower cost to your organization. There are many excellent websites that go into much more detail about the differences between a review and an audit.

Another option would be bi-annual, or even tri-annual audits, instead of doing one every year. This might be particularly attractive in cases where the related funding occurs over multiple years. Spreading the cost of a periodic audit over two or three years can make the reality of an audit requirement by your funders more affordable. Choosing an audit firm under this scenario may be more challenging, though, as some firms won't want to be engaged under this kind of arrangement.

A third possibility is that the funder would allow the cost of the audit, or a substantial subsidy towards the cost of the audit, to be paid out of the grant itself. This would be a stronger possibility if the funder permits some portion of the grant to be used for administrative costs.

With respect to donors, it is important to help them move away from the notion that audits represent unnecessary cost, or represent a "non-value add" to your mission. An audit report containing an unqualified opinion is the single most effective method for demonstrating transparency, accountability, and sound organizational governance to your donors, as well as your funders. The existence of an audit and what it represents in terms of time, effort, and cost, is the very strongest evidence that your organization is serious about accepting the fiduciary responsibilities that are a part of the daily pursuit of your mission. This should be good news to your donors!

A final word on auditors: when your organization makes the decision to engage an auditing firm, make sure you don't simply shop for the cheapest result. Instead, conduct your search as though you were looking for a business partner who can help your organization become stronger, more viable and better equipped to achieve its mission. This is what you should expect from the audit relationship.

For another take on audits, read an [article on Blue Avocado](#) by Dennis Walsh.



## Question

We are an independent school with around 160 pre-school and elementary students and 30 staff members (including teachers). What financial controls and management practices should we have in place to ensure that our assets are adequately protected?

Thank you for considering our question,  
Pat Baker, Executive Director, Bixby School

## Answer

### Financial Controls: It's All in the Details

Dear Pat,

Financial controls are really just a system of financial checks and balances that protects your organization from mismanagement, ensures data is reliable, and promotes operational efficiency and optimal use of resources.

The most important elements in maintaining good financial controls are to create a clearly-defined organizational structure with identified roles of authority; to ensure one person doesn't take care of every aspect of a financial transaction, separating duties with the system; to use outside sources to reconcile the organization's records; to have a budget and practices for regular review of budget vs. actual; and last but not least, to take care to hold a regular outside review (e.g. *audit*).

Internal controls are especially relevant to the management of cash receipts, cash disbursement, fixed assets, and petty cash. Here are the basics:

- Cash Receipts:
  - Avoid the acceptance or use of cash whenever possible and focus on checks.
  - Deposit checks quickly.
  - Check receiving, processing, recording and reconciliation functions should be handled by separate people.
  - When receiving a large number of checks or cash at one time, due to a fundraising event, for example, have two people work together to count, with one of them depositing the money and the other creating the accounting record.
- Cash Disbursement:
  - Once again, each step of the process should be segregated
  - Require advance approval for expenditures.
  - Pre-number all checks.
  - Expect supporting documentation for each expense.
  - Give time and attention to check-signing and make sure the signer is never writing the check.
  - Never sign a blank check.
  - Create a process for paying invoices that ensures they will be paid in a timely manner and once.
  - Have your bank send the monthly bank statement to the treasurer, as long as s/he is not the check signer, and that person should reconcile the accounts.
- Fixed Assets
  - Require that all fixed asset purchases be approved by the board in advance.
  - Maintain a fixed asset ledger with a list of all assets, date of purchase, price, etc.
  - Conduct yearly inventories.

Continued on Page 3



## *Financial Controls Answer Continued*

- Petty Cash
  - There should be one person responsible for disbursing petty cash.
  - Require a signed request or receipt.
  - Assign one other person to perform a regular reconciliation of the cash.

When it comes to other oversight practices, make sure your organization

- Conducts a monthly executive and board review of budget vs actual.
- Procures a yearly audit, review or compilation but an outside agent.

One can find wonderful additional resources on this topic on the governance resource website, Blue Avocado. [Click here](#) for an article written by Carl Ho.

## **Question**

**The recession has impacted our funding and things are only getting worse. Someone suggested we use rolling budgets. Can you tell me what a rolling budget is and how to use it or if there are other ways to adapt our budget to changing circumstances?**

**Thank you, Anonymous Executive Director**

## **Answer**

### **Budgeting: Don't just "Set It and Forget It"**

To set the stage for my answer, let's first talk about the purpose of a budget. Most importantly, it is a management tool to assist the leaders of your organization in making good financial decisions. Its purpose is to help your organization understand its' financial health and to prioritize your spending, projects, program initiatives, etc.

Most organizations put a new annual budget in place at the start of each new year (either fiscal or calendar). Then they don't change it until their next annual planning/budget meetings a year later. This is a flawed approach to the financial management of an organization, because, as we all know, things change. In fact it's almost certain that your budget is out of date within a month or so of writing it. So why then do we keep working the same game plan, when circumstances have changed? You shouldn't. Instead update and revise the plan to account for all the new situational information you have. The financial planning concepts of forecasting and rolling budgets are designed to account for these changes on an on-going basis.

### Forecasting

It is a best practice for your organization to thoroughly review your actual financial results vs. budget each month (or at a minimum each quarter). Many organizations do this. However, step #2 is actually more important, and that is to reassess the situation, discuss new priorities, evaluate changes, and then to re-project the remaining periods in your budget. Save your original budget – don't throw it away. But, call this new revised projection a Forecast.

Let's look at an example. Perhaps your Budget calls for spending \$500/month on marketing, but your revenue is down significantly vs. where you expected to be right now. So what does your management do? Are you going to cut expenses? Or, are you going to keep spending the original budget amount? Or, are you going to spend more on

*Continued on Page 4*



## *Budgeting Answer Continued*

marketing to try and drive more donations? I can't answer that question for you. But if your management decision is different than the original Budget...then by all means change the financial projections to account for this decision! This is your new Forecast.

Here's another example closer to home. What if you lost your job? Would you change your family's household budget to account for this new situation? Or would you keep spending the same because your family has a budget in Quicken that you put together at the beginning of the year. Of course not. You'd change your spending and figure out a new plan until you found another job. Don't treat your organization any differently than you would your household budget.

My point is to reassess your situation periodically and forecast what you think the rest of the year will look like, based on all the new information you have. This will build an agile and adaptive organization that is both quick to capitalize on new opportunities and is responsive to protect the organization when things go badly.

### Rolling Forecast

*Now that you are forecasting your financials, the next thing to do is to incorporate the concept of a rolling forecast, also known as a continuous budget. All this means is that you are always looking forward the SAME AMOUNT OF TIME when you re-project your financials. Why is it that we set the Budget once a year to look forward 12 months, then count down every month with a shorter, and shorter, and shorter future forecast? This makes no sense. Good financial planning is like having a strong set of headlights on your vehicle. The further you can see in front of you in the dark, the better.*

*A rolling forecast is a twelve-month budget that rolls forward monthly or quarterly as the current month or quarter has been completed. In the month of June your budget would be from July to June of the next year. You would be adding to your budget at the end of each period instead of doing an annual budget once a year. (This helps decrease the time spent on an annual budget by breaking it down into 12 manageable monthly increments.) In these difficult financial times the key to survival is cash. To develop a budget for your income and expenses is important, but a forecast for your cash will keep your agency better informed and on task.*

*Here's an example. Your team drafts a budget for 2011 and gets it approved in January 2011. Then you go 3 months. Your management and Board evaluate the first quarter (Q1) results in April 2011. Together you reprioritize and update your game plan. Then you forecast what you think 2011 will look like for Q2, Q3 and Q4. But don't stop there! Push out your forecast 1 more quarter into Q1 of 2012. This way you are always trying to do your best to look forward 1 year. That's a rolling forecast. It's as simple as that.*

*A Cash Burn Rate forecast breaks down your cash in-put and out-put. It is an easy calculation using your P&L and Balance Sheet. View a sample excel file with Rolling Budget and a Cash Burn Forecast.*



## Question

**Our board and staff are in disagreement about what financial information should be shared with the board and with donors. What are the best practices in financial reporting to the board of directors and to donors?  
Thank you for doing this program, Anonymous Board Member**

## Answer

### **Financial Reporting: Being Transparent with your Constituencies**

While the answers for these two constituencies may vary slightly, both should be guided by a societal expectation for disclosure and transparency. After the debacle of Enron federal laws (the Sarbanes–Oxley Act of 2002, also known as the “Public Company Accounting Reform and Investor Protection Act”) went into effect to guarantee dramatically increased forms of disclosure and regular reporting for all for-profit companies. Over the past several years, many states have passed laws requiring equivalent reporting and policy requirements for not-for-profits. While Colorado has not yet joined those states, many non-profits in the area have adopted equivalent accounting and policy reforms to assure greater disclosure and transparency.

To specifically answer your question, the Board has ultimate fiduciary responsibility for the organization, and hence the individual Board members have a right to see any and all financial information that is available. While they have the right, this does not mean that they should see every financial detail available on a regular basis. The ED or CEO should make judicious choices of what is presented, and then be open and responsive in providing additional details as desired or needed.

On a regular (monthly or quarterly as appropriate) basis, Board members should be given the following:

- A statement of activities (elements of revenue and expense) showing actual revenue and expense compared to the budget, highlighting variances from the plan.
- The same statement of activities showing actual revenue and expense compared with the same period for the previous year, again with variances.
- A statement of financial position, summarizing assets, liabilities and net assets, ideally comparing this with the equivalent time period for the previous year.
- On an annual basis, the audited statements and the accompanying management letter identifying concerns, qualifications, etc.
- On an annual basis, the Form 990 should also be reviewed along with the audit.

For donors, they are probably less interested in the details, but instead would be focused on the stability and soundness of the organization. The details one might share with donor include:

- The size of the budget.
- The number of consecutive years the organization has had a positive operating budget.
- A commentary on receiving clean audits for a number of years.
- A breakout of income sources demonstrating what type of support your organization receives such as government grants, foundation grants, earned income, corporate support, and individual donations.
- The functional breakout of expenses that must be included in the 990, showing the percentage of funds spent on programming, administration and fundraising.
- If the donor wants more information, consider sharing the audit results (*but NOT the management letter*).

Again, the emphasis should be on disclosure and transparency.